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SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961.

No. 447.

ESTATE OF THALIA E. GRAFF SMITH, DECEASED, SYLVESTER C. SMITH, JR., EXECUTOR, and SYLVESTER C. SMITH, JR.,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MARK G. ANTON and ADELE B. ANTON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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IN THE

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No. .

ESTATE OF THALIA E. GRAFF SMITH, Deceased, SYLVESTER C. SMITH, JR., Executor, and SYLVESTER C. SMITH, JR.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MARK G. ANTON AND ADELE B. ANTON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, The Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners, Estate of Thalia E. Graff Smith, Deceased, Sylvester C. Smith, Jr., Executor, and Sylvester C. Smith, Jr.; and, Mark G. Anton and Adele B. Anton, pray, through

their counsel, Samuel J. Foosaner, that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered in the above entitled action, in its decision dated June 30, 1961.

Opinion Below.

This consolidated proceeding was tried in the Tax Court of the United States before the Honorable Judge J. Gregory Bruce, upon a full Stipulation of Facts. The opinion of the Honorable Judge J. Edgar Murdock is reported at 34 T. C. No. 86. The Petitioners appealed to the United States Court of Appeals for the Third Circuit. The judgment of the Third Circuit, affirming the decision of the Tax Court was rendered and entered on June 30, 1961.

Jurisdiction.

The decision of the United States Court of Appeals for the Third Circuit was entered on June 30, 1961. Jurisdiction of this Court is invoked under 28 U. S. C. A. 1254(1).

Question Presented.

Whether dividends payable to stockholders of record on a fixed date are chargeable to them, or to the owners of the stock on the declaration date, who, prior to the record date, had divested themselves of complete ownership of the stock?

Statement of the Case.

On April 17, 1953, the directors of a personal holding company, declared a deficiency dividend to be paid on May 10, 1953, to the stockbrokers of record, as of that date. On May 9, 1953, one day prior to the record date, the principal stockholders made gifts of a portion of their said stock to their children. The subsequent May 10th distribution of dividends on the shares so given to the children was reported by the children-donees in their respective incomes for tax purposes. The Commissioner determined that the payments received by the children were chargeable as income to the Petitioners, the donors of the stock.

The Court's decision was based upon the conclusion that the declaration of the dividend created a debtor-creditor relationship between the corporation and its then stockholders, and that the donor-stockholders had a vested right in the dividends as of the date of its declaration. In affirming the decision of the Tax Court, the United States Court of Appeals for the Third Circuit agreed that upon the dividend being declared, the petitioner-donors acquired a vested right to the payment of a specified sum as of the record date.

Reasons for Granting the Writ.

1. The decision below conflicts with applicable decisions of this Honorable Court, and with decisions of other Circuit Courts of Appeal.

2. The Court below decided an important question of federal law which has not been, but should be settled by the Supreme Court.

3. A uniform application of the law is required in the taxation of property rights. It is, therefore, essential that a controlling decision now be rendered to completely dissipate the utter confusion which will otherwise prevail.

4. The decision of the Court below is erroneous.

Conflict in Controlling Law and Circuit Court Decisions.

This Honorable Court has clearly held, in the case of *Estate of Putnam* v. *Commissioner,* 324 U. S. 393 (1945), that a stockholder does not have the right to receive payment of a dividend upon its declaration where a future record date is fixed. This is so, because the corporate resolution, a purely voluntary act of the corporate board of directors, which provides for the payment as of a certain date, not only determines the earliest time for possible receipt, but also who the distributees are. Treasury Regulations 118, Section 39.115(a)-1(d).

The Court below, in holding that the Petitioner-Stockholders as of the declaration date were vested with a right to the dividend is in direct conflict with the Supreme Court decisions in the *Putnam* case and *Avery* v. *Commissioner,* 292 U. S. 210 (1933).

Further conflict now exists between the decision below and the conclusion of *Commissioner* v. *American Light & Traction Co.,* 156 F. 2d 398 (1946), in the Seventh Circuit; *Tar Products* v. *Commissioner,* 130 F. 2d 866 (C. C. A. 3rd 1942). This conflict is further complicated by the decision below and those in other circuits as to whether state or federal law is dispositive of the issue. *Helvering* v. *McGlue's Estate,* 119 F. 2d 167 (C. C. A. 4th 1941); *Commissioner* v. *Cohen,* 121 F. 2d 348 (C. C. A. 5th 1941).

The Court below ruled that the taxable recipient is to be determined under state law, and that such law is controlling. The taxation of corporate profits and dividends is a matter of federal law, not state law, and must be uniformly applied unless Congress has shown an intention to permit the taxation of dividends to be varied by state law. The incidence of dividend taxation being a federal responsibility, the Court below improperly rested its decision on state law. The fact that stockholders as a class may, for certain corporate purposes, be treated as creditors of the corporation after the declaration of a dividend, should not be determinative in a tax case where the relationship of the parties are examined for quite different purposes. The myriad creditor relationships and rights existing in each state does not determine the federal responsibilities of corporate and individual taxation. It would be intolerable to find that dividends are taxable differently from state to state.

Conflict in Application of Federal and State Law.

Alternatively, were state law to control, the Court below improperly applied this law in arriving at its decision. The Circuit Court, in support of its position, stated that once a corporate dividend is declared, a debtor-creditor relationship arises between it and its then stockholders, under New Jersey law, and the right to the earnings of the corporation becomes vested in the stockholders as of that date, notwithstanding the fixing of a future record date. The Court cited *Martindell* v. *Fiduciary, Inc.*, 133 N. J. Eq. 408, 30 A. 2d 281 (1943); *Beattie* v. *Gedney*, 99 N. J. Eq. 207, 132 Atl. 652 (1926); *In re: Heller's Estate,*

14 N. J. Super. 152, 81 A. 2d 418 (1951). But it is humbly observed that ea h of the cases so cited deals with the mere declaration of dividends. In none of them is a record date fixed for the dividend payment.

Since the declaration of a dividend constitutes a voluntary act on the part of the board of directors, it legally follows that such board may also fix the date upon which its obligation to its shareholders shall come into being. This is to be clearly drawn from the corporation law of the State of New Jersey. New Jersey Statutes Annotated, Section 14:8-20.

Where a record date is fixed, no identifiable debtor-creditor relationship can arise, *prior to such date.* (Italics supplied). It is a fixed rule of federal taxation that earnings and profits of a corporation do not become the property of the stockholders-owners, until the board of directors, by proper resolution, determines the date on which such earnings or profits, and the amount thereof, are payable. *Putnam, supra.* This constitutes an important question involving federal law which requires resolution of this Court.

The lower Court, having erroneously found, in the instant case, that a debtor-creditor relationship was created between it and the Petitioner-donors upon the mere declaration of a dividend, notwithstanding the corporate resolution fixing a specified record date for payment, held that the case of *Helvering* v. *Horst,* 311 U. S. 112 (1940), was controlling. But does such finding logically follow? In that case, this Honorable Court held that a donor of interest coupons was taxable on the interest because he retained ownership of the bonds which produced the interest. He

kept the tree, disposing only of its fruit. Moreover, the interest had already been earned on the date the coupons were transferred. Admittedly, the thrust of the *Horst* case would apply even if the bonds had also been transferred, since the interest had already been earned. But the decision in the *Horst* case does not justify holding the Petitioner-stockholders taxable herein. In the instant case, the Petitioners not only gave the stock itself, but at the date of transfer, no dividends had accrued.

It is respectfully urged that each parent did not transfer any right to a dividend to his child. He transferred shares of stock to which a right had not accrued, either under state or federal law. Herein lies a most vital distinction.

Conflict with Supreme Court Decisions.

The decision below conflicts with the well-established principles of income taxation laid down by this Honorable Court in the case of *Blair* v. *Commissioner,* 300 U. S. 5 (1937). That decision holds that income can only be taxable to the owner of property. The owners of the stock as of the date when the dividends were due and payable in the instant case, were the donee-children and not the donor-petitioners. Under the New Jersey law, to which federal tax consequences attach, the board of directors of a corporation only is empowered to declare dividends, and it is for it to simultaneously determine the stockholder of what record date shall be entitled to such dividends. New Jersey Statutes Annotated, Section 14:8-20. To tax Petitioners on income to which they had no right contravenes the basic principles of taxation.

The decisions below seek to confine and limit the application of the holdings of this Honorable Court in the *Putnam* case and *U. S.* v. *Anderson,* 269 U. S. 422 (1926). Such limitation is not warranted. The Court, in the *Putnam* case, stated on page 399 that:

> "Under the income tax acts, no stockholder has a separate and divisible taxable interest in the assets of a corporation, even though those assets have been increased by earnings. Earnings, before declaration of dividends, while increasing the value of his stock, have never been treated as an event to mark taxable income to the stockholder. Mere declaration of a dividend does not alter the stockholder's interest in the corporate assets. The stockholder can acquire no interest in the dividend, amounting to an accrual under section 42 (Revenue Act of 1938) before the amount of the dividend and *the distributee is determined.*" (Italics supplied.)

The Court below concluded that this Honorable Court reached this decision as a matter of "practical considerations of fairness and convenience", in the case of an accrual basis taxpayer. It is respectfully suggested that such conclusion is not warranted.

Uniformity Required.

Uniformity in the corporate and financial world in the treatment of dividends necessitates a controlling decision by the Supreme Court. The rules as to stock sold are correctly stated in Treasury Regulations 118, Section 39.22(a)-1(d), which provides, in part as follows:

> "The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is in-

fluenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. * * *"

The current Treasury Regulations, at Section 1.61-9 (c), likewise provide:

"When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. *When stock is sold between the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him.* * * *" (Italics supplied).

The Commissioner, in his rulings, and the Tax Court, in its decisions, have held that the entire amount of a dividend, upon becoming due and payable as of the record date, is income to the new owner. Revenue Ruling 56-211, 1956—1 CB 155. *Your Federal Income Tax* (1953), publication of Bureau of Internal Revenue; *Julius S. Rippel, et al.* v. *Commissioner*, 13 B. T. A. 438 (1928); *Marcus Frieder* v. *Commissioner*, 27 B. T. A. 1239 (1933). The very source of the dividend, corporate surplus, is not diminished until the record date. How can this tax consequence be reconciled with the Court below's view that the stockholder receives a vested right to corporate surplus immediately

upon the declaration of a dividend? The Court below, in commenting upon these settled areas of taxation, stated that none of the considerations and complexities involved in such cases were present here, adding further that its holding neither controls nor is controlled by rulings whether sales have yielded capital gains or ordinary income. Federal tax consequences should apply alike to all stock transfers, whether they be sales or gifts, and to all corporate-dividend transactions. Uniformity and certainty regarding the federal tax consequences of dividends between the stockholders on the declaration date and the stockholders on the record date is required by a decision of this Honorable Court.

Conclusion.

A matter of substantial importance governed by federal law is presented herewith; and for the reasons hereinabove stated, it is respectfully requested that this Petition for a Writ of Certiorari be granted.

Respectfully submitted,

SAMUEL J. FOOSANER,
FOOSANER, SAIBER AND SCHLESINGER,
Counsel for Petitioners,
11 Commerce Street,
Newark, New Jersey.

Dated: September 1961.

APPENDIX.

Motion for Consolidation.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT.

Docket Nos. 13,466 and 13,467.

COMES NOW, the Estate of Thalia E. Graff Smith, Deceased, Sylvester C. Smith, Jr., Executor, and Sylvester C. Smith, Jr., and Mark G. Anton and Adele B. Anton, by their attorney, Samuel J. Foosaner, and showing that the dividend issue herein involved is common to both cases, moves that the above docketed cases be consolidated.

Therefore, it is prayed that this Motion be granted.

SAMUEL J. FOOSANER,
Counsel for Petitioner,
11 Commerce Street,
Newark, New Jersey.

Jan. 5, 1961

MOTION GRANTED
KALODNER,
J.

Opinion of the Court.

(Filed June 30, 1961.)

Argued April 7, 1961

Before:

GOODRICH, McLAUGHLIN and HASTIE, *Circuit Judges.*

By: HASTIE, Circuit Judge.

On April 17, 1953, the directors of a personal holding company, a New Jersey corporation, declared a dividend to be paid on May 10, 1953, to the stockholders then of record. On May 9, 1953, the principal stockholders gave certain shares of their stock to their several children. Thereafter, the May 10th distribution of dividends on those shares was made to the children, who reported the amounts thus received as their income. However, in the present proceeding the Commissioner has assessed deficiencies against the parents, treating the dividend payments to the children as realization of income by the parents. The Tax Court sustained this position and the parents have appealed.

At the outset, it seems clear that whenever a lawful dividend on particular stock is fully declared each stockholder becomes a creditor of the corporation with a vested right to be paid a specified sum at some future time. Since this is a matter of defining the intra-corporate property rights created by the declaration of a dividend by a New Jersey corporation, New Jersey law is controlling. Federal law merely attaches tax consequences to the rights thus created. A number of New Jersey cases recognize and apply the above stated rule as to the effect of a declaration of a dividend. *Martindell* v. *Fiduciary Counsel, Inc.*, 1943, 133 N. J. Eq. 408, 30 A. 2d 281; *Beattie* v. *Gedney*, 1926, 99 N. J. Eq. 207, 132 Atl. 652; *In re Heller's Estate*, 1951, 14 N. J. Super. 152, 81 A. 2d 418. Appellant urges that this

rule is inapplicable if in declaring the dividend the directors of the corporation fix a particular future date for the determination of the payees. But we find nothing in the New Jersey cases or in sound reason to warrant such a limitation. We are satisfied that, as a stockholder at the time a dividend was lawfully declared, each parent acquired a vested right to the payment of a specified sum on May 10, and that he transferred this right to his child the day before the May 10th record date.

Certainly these dividends which were both declared and distributed in 1953 were ordinary income taxable in that year either to the parents or the children, depending upon whether in legal contemplation the donor or the donee realized the income. On this question whether parent or child realized income, we think *Helvering* v. *Horst*, 1940, 311 U. S. 112, is controlling. In that case a father owned negotiable bonds. He detached negotiable interest coupons from the bonds shortly before the due date of the coupons and gave the coupons to his son. In determining whether father or son realized income the Supreme Court reasoned as follows:

> "Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives

> the money, he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named." 311 U. S. at 117.

In exactly the same way each parent here realized the economic benefit he wished to derive from his dividend rights through his gift, followed almost immediately by the corporation's payment to his child. Such dealing by a parent with his vested right to a lawfully declared dividend, is not significantly different from the gift of negotiable interest coupons in the *Horst* case.

Seeking to avoid the impact of the *Horst* decision the petitioners point out that there the interest coupons alone were given away. But in both cases the right to the earnings in question was a vested right to receive a determined amount of fully earned gain. Such a right is distinct from the stock ownership, though derived from it. In the horticultural metaphor which has become familiar in cases of this type, "the fruit had ripened" before the gift. In these circumstances, we see no reason why the rule of the *Horst* case should not be as fully applicable to a gift of the fruit with the tree as to a gift of the fruit alone. This was recognized by the Tax Court in *Estate of Bertha May Holmes,* 1943, 1, T. C. 508. We quote, with entire approval, that court's reasoning as to the reach of the *Horst* doctrine:

> "It is true that in the *Horst* case, Horst remained the owner of the bonds from which the coupons were detached until after the maturity date of the coupons,

> whereas in the instant case the decedent gave to her son and daughter not only the credited accumulated dividends, but the shares of stock as well. However, it would be difficult to see why, if the gift by the owner of accrued interest represented by negotiable coupons not yet due, which he detached from bonds of which he remained the owner and which were collected by the donee in the same taxable year, represented a realization by the donor of the accrued interest, yet the gift of dividends which had already been credited on stock did not represent realization of income by the owner merely because at the same time that she made the gift of the dividends she also gave away the stock * * * The only importance which attaches to the fact that Horst remained the owner of the bond was as to interest which accrued *after* the date of the gift. In other words, as we construe the meaning of the Supreme Court's opinion in the *Horst* case, it is this: that all the fruit of the tree that had grown on the tree at the time of the gift and was plucked by the donee in the same year as the gift was as effectively gathered by the owner of the tree as if he had plucked the fruit himself." 1 T. C. at 511, 512.

We have also considered petitioner's reliance on *Estate of Putnam* v. *Commissioner*, 1945, 324 U. S. 393. There a stockholder who was a cash-basis taxpayer died after a dividend had been declared but before the record date. The question presented was whether this gain was taxable income of the final period of the testator himself or was properly includable in the first return of his estate. A difference between tax brackets made the assignment of this item important. The Supreme Court concluded that this dividend income was allocable to the period after the testator's death and, therefore, should be reported as in-

come of his estate. Practical considerations of fairness and convenience may dictate that this rule as to the time of reporting dividend income should apply even to accrual basis taxpayers. *Commissioner* v. *American Light & Traction Co.*, 7th Cir. 1946, 156 F. 2d 398; cf. *Tar Products Corp.* v. *Commissioner*, 3d Cir. 1942, 130 F. 2d 866. But for present purposes such decisions indicate merely that, even if the parents here had themselves retained the stock and received the dividends they would properly have accounted for this income in the year of distribution rather than the year of declaration, assuming the two had been different. But such determination of the proper time of accounting does not help us solve the present problem, whether the donor or donee of the right to the dividend is the person legally required to pay the tax upon it.

Finally, the petitioners seek to find some analogy in cases presenting those difficult problems of choice between capital gains and ordinary income treatment which often arise when part of the gain realized on a sale of securities represents the value of accrued interest, original issue discount, or declared, accumulated or expected dividends. But we have here none of the considerations and complexities involved in such sale cases. This is merely a case where an intra-family gift has occurred in connection with transactions which clearly yielded some member of the family ordinary income. Which member is determined by deciding who should be viewed as realizing the taxable gain. Our holding in this case neither controls nor is controlled by rulings whether sales have yielded capital gains or ordinary income.

The decision of the Tax Court will be affirmed.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Judgment.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 13,466

Estate of Thalia E. Graff Smith, Deceased, Sylvester C. Smith, Jr., Executor, and Sylvester C. Smith, Jr.,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

On Petition to Review a Decision of the Tax Court of the United States

Present: GOODRICH, McLAUGHLIN and HASTIE,
Circuit Judges.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF
Clerk

June 30, 1961

Received and filed
June 30, 1961
Ida O. Creskoff
Clerk

Judgment.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 13,467

Mark G. Anton and Adele B. Anton,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

On Petition to Review a Decision of the Tax Court of the United States

Present: GOODRICH, MCLAUGHLIN and HASTIE,
Circuit Judges.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF
Clerk

June 30, 1961

Received and filed
June 30, 1961
Ida O. Creskoff
Clerk

Mandate.

UNITED STATES OF AMERICA, ss:

THE PRESIDENT OF THE UNITED STATES OF AMERICA

To the Tax Court of the United States

GREETING:

WHEREAS, lately in the Tax Court of the United States before you or some of you, in a cause between Estate of Thalia E. Graff Smith, Deceased, Sylvester C. Smith, Jr., Executor, and Sylvester C. Smith, Jr., Petitioners and Commissioner of Internal Revenue, Respondent, a decision was entered in the Tax Court on August 25, 1960, which decision is of record in the office of the Clerk of the said Tax Court (Tax Court Docket No. 74366) to which reference is hereby made, and the same is hereby expressly made a part hereof, as by inspection of the record of the said Tax Court of the United States which was brought into the United States Court of Appeals for the Third Circuit by virtue of a petition for review by Estate of Thalia E. Graff Smith, Deceased, Sylvester C. Smith, Jr., Executor, and Sylvester C. Smith, Jr., agreeably to the Act of Congress, in such case made and provided, more fully and at large appears.

AND WHEREAS, the said cause came on to be heard before the United States Court of Appeals for the Third Circuit, on the said record, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

June 30, 1961

Mandate.

UNITED STATES OF AMERICA, ss:

THE PRESIDENT OF THE UNITED STATES OF AMERICA

To the Tax Court of the United States

GREETING:

WHEREAS, lately in the Tax Court of the United States before you or some of you, in a cause between Mark G. Anton and Adele B. Anton, Petitioners, and Commissioner of Internal Revenue, Respondent, a decision was entered in the Tax Court on August 25, 1960, which decision is of record in the office of the Clerk of the said Tax Court (Tax Court Docket No. 74337) to which reference is hereby made, and the same is hereby expressly made a part hereof, as by inspection of the record of the said Tax Court of the United States which was brought into the United States Court of Appeals for the Third Circuit by virtue of a petition for review by Mark G. Anton and Adele B. Anton, agreeably to the Act of Congress, in such case made and provided, more fully and at large appears.

AND WHEREAS, the said cause came on to be heard before the said United States Court of Appeals for the Third Circuit, on the said record, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

June 30, 1961

Office-Supreme Court, U.S.
FILED
DEC 20 1961
JOHN F. DAVIS, CLERK

No. 447

In the Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF THALIA E. GRAFF SMITH, DECEASED, SYLVESTER C. SMITH, JR., EXECUTOR, AND SYLVESTER C. SMITH, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MARK G. ANTON AND ADELE B. ANTON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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Treasury Regulations on Income Tax (1954 Code) Section 1.61–9(c)	5, 8

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 447

ESTATE OF THALIA E. GRAFF SMITH, DECEASED, SYLVESTER C. SMITH, JR., EXECUTOR, AND SYLVESTER C. SMITH, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MARK G. ANTON AND ADELE B. ANTON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 36a–39a)[1] is reported at 34 T.C. 842. The opinion of the Court of Appeals (Pet. 12–16) is reported at 292 F. 2d 478.

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[1] "R" references are to the appendix to the petitioners' brief in the Court of Appeals which has been filed as a part of the record in this Court.

JURISDICTION

The judgments of the Court of Appeals were entered on June 30, 1961. (Pet. 17–18.) The petition for a writ of certiorari was filed on September 27, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

A personal holding company of which the petitioners were the controlling stockholders and which had substantial undistributed earnings declared a so-called deficiency dividend (pursuant to 1939 Code Section 506) in order to eliminate an agreed deficiency in personal holding company surtax on the undistributed earnings and, instead, subject the earnings to tax in the hands of the stockholders. The day before the deficiency dividend was paid the petitioners donated a part of their stock to their children, who collected the dividend. The question is whether the gift served to relieve the parent-donors of income tax liability on the deficiency dividend paid on the shares of stock given to their children.

STATEMENT

The petitioners and their families owned all the stock of the S.B.N. Gas Company, a New Jersey corporation. This corporation was a personal holding company because of the limited ownership of its stock and the nature of its income.[1] (R. 31a, 37a.)

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[1] A corporation is a personal holding company, under Sections 501 and 502 of the Internal Revenue Code of 1939, when more than 50 percent of the stock is owned, directly or indirectly, by or for not more than five individuals and at least

The Commissioner determined deficiencies totalling $88,262.98 in the corporation's income tax and personal holding company surtax for the years 1947–1950. On March 25, 1953, the Commissioner and the corporation entered into a closing agreement establishing the personal holding company surtax liability in the amount of $69,857.61. (R. 31a, 37a.)

The personal holding company surtax is imposed upon the "undistributed personal holding company income" (Section 500). A deficiency in the tax may be reduced, however, by the distribution of a "deficiency dividend" if the personal holding company complies with the conditions stated in the Internal Revenue Code and the Regulations (Section 506; Treas. Reg. 118, Sections 39.506–1, 39.506–3). In brief, the company is allowed 60 days after it has been finally determined to be a personal holding company within which to declare and pay a deficiency dividend and to file a claim for credit or refund based upon that distribution of its accumulated earnings.

The corporation here proceeded to take advantage of these relief provisions. The minutes of a special meeting of the board of directors, dated April 17, 1953, recite that the corporation had been advised that it would be permitted to declare dividends which could be applied against its surtaxes for prior years and thus wipe out substantially all of its unpaid de-

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80 percent of the corporation's gross income is derived from such investment sources as dividends, interests, royalties, annuities, stock and security transactions, commodities transactions, personal service contracts and rents.

ficiencies. Dividends in the amount of $83,118 were declared at the April 17 meeting, payable on May 10, 1953 to stockholders then of record. The corporation then had accumulated earnings and profits of $604,-929.66. (R. 32a, 37a–38a.)

The corporation paid the dividends as declared. But one day before payment date, on May 9, 1953, petitioner, Mark Anton, gave 56 shares of his stock to each of his two children and petitioner, Sylvester Smith, Jr., gave 35 shares of stock to each of his two children. The dividends allocable to these shares ($18,008.90) were paid to the children on the following day. The Commission determined that the dividends paid to the children were includible in the income of the donor-parents. (R. 38a.)

The Tax Court sustained the Commissioner's determination, holding that the transfer of the stock did not relieve the donors of income tax on the deficiency dividend previously declared and paid the day following the transfer. (R. 39a.) The Court of Appeals affirmed. (Pet. 16.)

ARGUMENT

Petitioners state that the question presented is—

> Whether dividends payable to stockholders of record on a fixed date are chargeable to them or to the owners of the stock on the declaration date, who, prior to the record date, had divested themselves of complete ownership of the stock.

If the case presented only this general question—if the decision below necessarily held that all original owners are taxable as a general rule and no special

circumstances were present—we would agree that the writ should be granted. It is a well established rule that in the case of arm's-length sales occurring between the declaration date and the later date as of which the dividends are distributable, the dividend is taxable to the owner on the record date. Treasury Regulations on Income Tax (1954), Sec. 1.61-9(c). The same rule has always been applied—and will continue to be applied by the government—to gifts in the absence of extraordinary circumstances. To the extent that the opinion below, as distinguished from the decision, may assert the contrary, we think that it is wrong.

But the instant case obviously does present extraordinary circumstances. The shareholders of a personal holding company availed themselves of the benefits of the deficiency dividend procedure for reducing the personal holding company surtax on undistributed earnings. Simultaneously, they sought to insulate themselves from the concomitant personal shareholder tax liability by making intra-family transfers of the stock just after the dividends were declared. In this situation, where the imminence of an extraordinarily large dividend by a personal holding company plays a determinative role in the timing of an intra-family gift, the transfer is an effort to make an impermissible shifting of income tax liability and therefore is not governed by the general rule.

In our view, the opinion below is to be read against the facts of this case. We submit therefore that certiorari should be denied, for on those facts there is no conflict of decisions or other occasion for further

review. If the Court, however, construes the opinion to mislead the tax bar by necessarily establishing a general rule inconsistent with Treasury policy and the government's reading of the law, the proper course would be to grant certiorari and either affirm the decision after argument upon the narrower ground or remand the case now for consideration of that ground in the court of appeals.

In the remainder of this brief we show (1) that the decision below is correct upon its facts and (2) the reasons for narrowly construing the decision of the court of appeals.

1. The decision below is correct upon the facts of this case. The personal holding company surtax is designed to require distribution of investment income in closely-held corporations otherwise taxed at lower rates than high-bracket individuals; thus it applies extremely high rates to the *undistributed* income of a corporation that qualifies by type of ownership and income as a personal holding company. Sections 500–507 of the Internal Revenue Code of 1939; S. Rep. No. 558, 73d Cong., 2d Sess., pp. 13, 15 (1939–1 Cum. Bull. (Part 2) 586, 596–597).

However, Congress recognized that bona fide differences of opinion as to personal holding company status or as to the amount of income required to be distributed might be resolved adversely to taxpayers at a time when it was too late to avoid the tax by distributing income. The deficiency dividend procedure alleviates this hardship by permitting a company to make a current distribution (reportable as income by the shareholders) that will in effect reduce the un-

distributed income of the prior years for which tax is asserted. Section 506; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 37–39 (1939–1 Cum. Bull. (Part 2) 779, 806–807). In the instant case the dividend distributed in 1953 wiped out substantially all the personal holding company tax liability for the years 1947, 1948, 1949, and 1950.

Since the rationale of the deficiency dividend procedure is that it permits a present distribution of income to shareholders to whom it should, in the view of Congress, have been distributed and taxed in other years, it is an essential part of the statutory plan that the deficiency dividends be taxable to the shareholders. Treasury Regulations 118, Section 39.115(a)–1, have always recognized this principle. Here the controlling shareholders of the personal holding company availed themselves of the procedure all the way to the point of reaching agreement with the Internal Revenue authorities on the four-year deficiency and deciding on and declaring the necessary deficiency dividend. They then, however, after setting a subsequent "record date" of no other practical significance, sought to escape the shareholder tax on the deficiency dividend by donating their shares to their children immediately prior to payment of the dividend. The decisons below correctly prevent the shareholders of a personal holding company from seeking to avail themselves of the benefits of the deficiency dividend procedure for reducing the personal holding company surtax on undistributed earnings, yet simultaneously insulating themselves from the concomitant personal shareholder tax on the undistributed earnings by

transferring their stock to their children after the right to the dividends has vested.[3] Such cases as *Helvering* v. *Horst*, 311 U.S. 112; *Harrison* v. *Schaffner*, 312 U.S. 579; and *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260,[4] while not strictly analogous, show the traditional skepticism with which tax law views such well-timed intra-family transfers.

We have noted above our acceptance of the general rule that dividends declared before, but payable to stockholders of record after, a gift of stock are taxable to the donee rather than to the donor. But even in the case of sales, that is only the *ordinary* rule and room for exceptions is provided to prevent the warping of a rule of convenience into a tool for manipulation. Treasury Regulations, Section 1.61–9(c) read in part:

> (c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend *ordinarily* is income to the seller. When stock is sold between the time

[3] In this context, the New Jersey decisions cited in the court below (Pet. 5–6), which hold that for many purposes under New Jersey law a debtor-creditor relationship exists between a shareholder and his corporation immediately after the declaration date, show that the anticipated income had ripened beyond a mere expectancy and thus could be considered a severable part of the gift.

[4] See also *Lucas* v. *Earl*, 281 U.S. 111; *Burnet* v. *Leininger*, 285 U.S. 136; *Corliss* v. *Bowers*, 281 U.S. 376; *Helvering* v. *Eubank*, 311 U.S. 122; *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4th); *Arnfeld* v. *United States*, 163 F. Supp. 865 (C. Cls.); *Doyle* v. *Commissioner*, 147 F. 2d 769 (C.A. 4th).

> of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend *ordinarily* is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. * * * [Emphasis supplied.]

Thus, even in dealing with sales, it was recognized that extraordinary circumstances would require departure from the general rule. Gifts are to be treated in identical fashion, save that special circumstances are more likely to arise in a situation in which there are no interests competing at arm's length and the taxing authority is the only adverse party.

2. The opinion of the Court of Appeals cannot be divorced from the facts of this case. The case results from the threatened imposition of a personal holding company surtax. The donors, who were faced with heavy personal income tax liabilities, controlled not only the timing of the gifts but also the mechanics and timing of the dividends. Only by a blind preference for form over substance can one say with petitioners that gifts in such circumstances must be governed by the same rules applied to ordinary gifts of stock that happen to occur shortly after a regular quarterly dividend has been declared.

Read against the facts of the case, the decision below is not in conflict with the cases cited by petitioner. In

Estate of Putnam v. *Commissioner,* 324 U.S. 393, the Court held only that on the death of a cash-basis taxpayer Section 42 of the 1939 Code did not require accrual of all declared dividends. Similarly, *Avery* v. *Commissioner,* 292 U.S. 210, and *Commissioner* v. *American Light & Traction Co.,* 156 F. 2d 398 (C.A. 7th), involved only questions as to the year in which a dividend became taxable, *i.e.,* whether the taxable event was declaration of the dividend, the record date, or the receipt of the dividend. The petitioners confuse the question of when the dividends became taxable income with the question of to whom the dividend was taxable. It is irrelevant that the dividends here had not technically "accrued" to the fathers for income tax purposes on the date of the gift.[8]

There is likewise no conflict with *Blair* v. *Commissioner,* 300 U.S. 5, where the life beneficiary of a trust assigned all of his interest in a part of his equitable estate. The Court there decided that an income beneficiary could effectively assign a vertical part of all that he had. No question was raised that the time of assignment was affected by any single anticipated dividend, extraordinary or otherwise.

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[8] *Tar Products Corp.* v. *Commissioner,* 130 F. 2d 866 (C.A. 3d), also cited by petitioners as in conflict, held the transferor was not taxable even where the transfer was after the record date and the check was sent to the transferor. The *Tar Products* decision is contrary not only to the instant case but also to most decisions in the field and to the uniform rules which petitioners espouse at pages 8–9 of their Petition. In view of the existing Regulations it cannot be said to be the source of any actual conflict today.

CONCLUSION

Limited to its particular facts, the decision below is correct. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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REPLY BRIEF FOR PETITIONERS.

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REPLY BRIEF FOR PETITIONERS.

The basic purpose of this Reply is to question the Commissioner's endeavor to distinguish deficiency dividends from other dividends. In the humble opinion of the Petitioners, the fact that the shareholders availed themselves

of a procedure to their tax advantage, in no way makes deficiency dividends any different than other dividends.

In opposing the Petition for the Writ of Certiorari, the Commissioner states:

> "If the Court, however, construes the opinion to mislead the tax bar by necessarily establishing a general rule inconsistent with Treasury policy and the government's reading of the law, the proper course would be to grant certiorari and either affirm the decision after argument upon the narrower ground or remand the case now for consideration of that ground in the court of appeals." (R. B. in O. p. 6).

The Commissioner also states that:

> "* * * if the decision below necessarily held that all original owners are taxable as a general rule and no special circumstances were present—we would agree that the writ should be granted." (R. B. in O. p. 4).

Petitioners respectfully urge that only such general question was determined and no justifiable ground exists for any narrower construction. The Third Circuit Court of Appeals makes no distinction whatsoever between deficiency dividends and other dividends, and none is warranted.

Deficiency dividends are treated as normal dividends with respect to the incidents of taxation in the hands of the recipient. Neither the Internal Revenue Code, nor the Regulations promulgated thereunder, changes the general rule of dividend taxation where deficiency dividends are concerned. For the Commissioner to assert otherwise is to

do so without legal support. Section 39.506-4 of Regulations 118, states with respect to deficiency dividends:

> "'The deficiency dividends' are required under Section 506 (c) to be paid prior to the filing of the claim for credit or refund and such dividends must be of such a nature as to constitute taxable dividends in the hands of such of the shareholders as are subject to taxation under Chapter I for the year in which paid (see section 27 (i)) and must be non-preferential (see section 27 (h))."

Particular notice must be taken of the words, "such shareholders as are subject to taxation under Chapter I for the year in which paid. * * *" The donees of the stock and the recipients of the dividends, the c. ldren, fully satisfy the definition of "shareholders subject to taxation under Chapter I for the year in which paid."

The Regulations charge the owner of the stock with the dividend for the year in which such dividend is paid. Nowhere in the Internal Revenue Code, the Regulations, nor in the case law, is there any requirement that the stockholders chargeable with dividend income, must be stockholders of the corporation at the time that the profits or income, from which the dividends are derived, be earned by the corporation. The stockholders need merely be the owners of the stock on the record date when the dividend is paid. Deficiency dividends, like all dividends, are charged to the owner of the stock for the year in which such dividends are paid.

It is humbly submitted that the dividends paid to the donees of the stock in the instant case, fully satisfy the requirements under Section 39.506-4 (3) of Regulations 118.

They were non-preferential and were fully taxable, and so reported by the shareholders for the period in which the distribution was made, as required by section 27 (h) and 27 (i), respectively, under the 1939 Internal Revenue Code.

The Commissioner's contention that different treatment be accorded deficiency dividends, constitutes an attempt to legislate, a function clearly not a matter for disposition by this Honorable Court.

Wherefore, it is respectfully prayed that the Petition for a Writ of Certiorari be granted.

Respectfully submitted,

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Counsel for Petitioners.

Dated: January 2, 1962.